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District Court in Knudsen Holds for the Debtors in Chapter 12 Case

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Issue Contents

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District Court in *Knudsen* Holds for the Debtors in Chapter 12 Case

-by Neil E. Harl*

In a decision that has drawn national attention in bankruptcy circles and promises to shape the prevailing interpretation of the 2005 Chapter 12 bankruptcy amendments pertaining to the tax treatment of Chapter 12 debtors,[1] the United States District Court for the Northern District of Iowa on June 12, 2008, handed down a 64-page decision that clearly carries out the legislative intent of the statute.[2] The case clears the way for Chapter 12 bankruptcy cases to proceed under what is now a workable provision (which was enacted in 2005) by the most influential court to date to deal with the earlier Congressional omission to provide for separate entity status for Chapter 12 bankruptcy filers.[3]

The 2005 enactment

In the Bankruptcy Abuse Prevention Act of 2005,[4] the Congress undertook to remedy the problem created in 1986 with the enactment of Chapter 12 bankruptcy[5] without specifying that filers under Chapter 12 would be in line for a new entity which has been the heart of a "fresh start" for income tax purposes for individuals filing under Chapters 7 and 11.[6] The approach in the 2005 legislation was to provide that a Chapter 12 debtor could treat liabilities arising out of "claims owed to a governmental unit," such as income tax on gain or recapture income as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an *unsecured* claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge.[7] By categorizing such "claims owed to a governmental unit" to be unsecured claims, rather than priority claims, the amounts would be eligible for discharge.

Bankruptcy court interpretations

In the first judicial interpretation of the 2005 language, *In re Knudsen,*[8] the Bankruptcy Court for the Northern District of Iowa first held that the language "farm asset used in the debtor's farming operation" limited the scope of the provision to assets used in the trade or business which are eligible for capital gain treatment under I.R.C. § 1231 (and, presumably, capital assets under I.R.C. § 1221) and was not sufficiently broad to embrace assets held for sale such as slaughter hogs or grain.[9] The court also held that, in allocating tax claims between those attributable to the sale of farm assets eligible for the special treatment allowing possible discharge, and those taxes under priority status, which are not eligible for possible discharge and must be paid in full in order to get the Chapter 12 plan confirmed, the method used should be to pro rate the taxes.[10] The debtor

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had argued for a marginal approach, which would be more favorable to the debtor because of the graduated income tax rates. These two findings by the Bankruptcy Court did not favor the debtor's position.

The Bankruptcy Court agreed with the debtor that the statutory language changes the character of the taxes from *priority* to *unsecured* status such that, at the time of discharge, the unpaid portion of the tax is discharged along with any interest or penalties.[11] The court agreed also that the relief provision in the 2005 legislation applied to post-petition taxes and, even though a separate estate is not created,[12] the taxes on the income of the debtors could be treated as administrative expenses.[13] The post-petition taxes on the sale of farm assets eligible for the special treatment are treated as an unsecured claim, not a priority claim.[14] Therefore, those post-petition taxes were dischargeable without payment in full *provided the amounts are provided for in the plan and the debtors receive a discharge*.[15] The Bankruptcy Court also indicated that it is appropriate to use a Chapter 12 liquidation analysis (which adds the portion of the tax treated as an unsecured claim to the traditional unsecured claims in determining whether the best-interest-of-creditors test is met) rather than the Chapter 7 liquidation analysis (which requires that the tax claim be treated as a priority claim to be paid in full).[16]

The case of *In re Knudsen*[17] was followed by a 2007 Arizona Bankruptcy Court decision, *In re* Hall, that held that post-petition sales of assets used in the debtor's farming operation did not qualify for the special treatment with tax claims treated as unsecured claims rather than as a priority claim and taxes on such sales could not be treated as administrative expenses of the bankruptcy estate.[18] That court was influenced by the argument that income tax arising from the post-petition sale of farm assets used in the debtor' farming operation could not be a tax "incurred" by the Chapter 12 estate[19] because the bankruptcy estate does not exist as a separate taxable entity.[20]

The Nebraska Bankruptcy Court, in *In re Schilke,*[21] followed *In re Knudsen* in holding that the bankruptcy estate had sufficient existence to support treatment of capital gains from the sale of estate property as a claim against the estate and not solely against the debtor outside of bankruptcy.

A 2008 decision by the Bankruptcy Court in Kansas, *In re Dawes,*[22] followed *In re Knudsen,* also, and held that the phrase "incurred by the estate" is ambiguous but, looking at the legislative history, determined that the phrase had reference to *when* the tax liability was incurred, not the entity having liability for the tax.[23] Accordingly, the taxes could be treated as administrative expenses and could be handled as unsecured claims.

The appellate decision

In a well-reasoned and persuasive opinion, the United States District Court for the Northern District of Iowa ordered the Bankruptcy Court to confirm the plan in the case of *In re Knudsen*.[24] The judge held that the sale of slaughter hogs qualified as assets used in the debtor's farming operation, finding that the "debtor's farming operation" is the debtor's farming operation under the reorganization plan and specifically rejected the narrow interpretation that the term "used in the debtor's farming operation" limited the scope of the provision to those assets covered by I.R.C. § 1231 (assets used in the trade or business with gains eligible for capital gains treatment) and I.R.C. § 1221 (capital assets).[25] The court upheld the Bankruptcy Court's conclusion that the 2005 enactment[26] applied to post-petition transfers, utilizing the rationale of *In re Dawes,*[27] and even though a separate estate is not created, the taxes could be treated as administrative expenses[28] which means the taxes could be handled as an unsecured claim.[29] The appellate court also adopted the marginal methodology as opposed to a model of pro rating the taxes.

What's next?

The big question is whether the *Knudsen* case will be appealed to the Eighth Circuit Court of Appeals and whether other cases may be appealed.

FOOTNOTES

[1] Bankruptcy Abuse Prevention and Consumer Protection Act of 2008 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005). See 11 U.S.C. § 1222(a)(2). See generally 5 Harl, *Agricultural Law* § 39.04[2][b][ii] (2008), 13 Harl, *Agricultural Law* § 120.08[9][a] (2008); 2 Harl, *Farm Income Tax Manual* § 9.05[7] (2007 ed.). See also Harl and Peiffer, "Bankruptcy Court Interpretation of Chapter 12 Tax Rules," 17 *Agric. L. Dig.* 185 (2006).

[2] *In re* Knudsen, 356 B.R. 480 (N.D. Iowa 2008).

[3] I.R.C. § 1398(a). See Harl and Peiffer, *supra* note 1 at 185.

[4] Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005), *adding* 11 U.S.C. § 1222(a)(2).

[5] Pub. L. No. 99-554, 100 Stat. 3105 (1986).

[6] I.R.C. § 1398(a).

[7] BAPCPA of 2005, § 1003, note 1 *supra*, adding 11 U.S.C. § 1222(a)(2).

[8] *In re* Knudsen, 356 B.R. 480 (Bankr. N.D. Iowa 2006).

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] I.R.C. § 1398(a).

[13] See 11 U.S.C. § 501(b)(1)(B).

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] Note 8 *supra*.

[18] *In re* Hall, 376 B.R. 741 (Bankr. D. Ariz. 2007).

[19] 11 U.S.C. § 503(b)(1)(B)(i).

[20] *Id.*

[21] 379 B.R. 899 (Bankr. D. Neb. 2007).

[22] 382 B.R. 509 (Bankr. D. Kan. 2008).

[23] See S. Rep. No. 95-1106, 95th Cong., 2d Sess. 13 (1978).

[24] 2008 U.S. Dist. LEXIS 46275 (N.D. Iowa 2008).

[25] *Id.*

[26] 11 U.S.C. § 1222(a)(2)(A).

[27] 382 B.R. 509 (Bankr. D. Kan. 2008).

[28] See 11 U.S.C. § 501(b)(1)(B).

[29] *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

AUTOMATIC STAY. The Chapter 12 debtors had defaulted on promissory notes given to a creditor cooperative for agricultural inputs. The creditor had filed suit in state court to collect on the unpaid notes and the debtors had filed a counter-claim that the cooperative had improperly provided the inputs and failed to properly market the debtor's crops. The debtors then filed for Chapter 12, staying the state court action. The cooperative filed a motion in the bankruptcy case for declaration that the debt was nondischargeable under Section 523(a)(2)(A) because the debtors had provided false financial information in applying for the promissory notes. The debtors again raised their counter-claim against the cooperative. The court held that the issue of dischargeability depended on the extent the debtors were liable on the promissory notes; therefore, the court granted the creditor relief from the automatic stay to complete the state court action and reserved the issue of dischargeability for after that trial. ***In re* Schnuelle, 2008 Bankr. LEXIS 1705 (Bankr. D. Neb. 2008)**.

DISMISSAL. The debtors filed for Chapter 12 and their primary debts were to the IRS for over 20 years of unpaid taxes. The IRS sought dismissal of the case for bad faith filing, noting that (1) the tax claims were nondischargeable; (2) the bankruptcy filing was made only to prevent foreclosure and not for reorganization; (3) the IRS has been prejudiced by the delay in enforcing its rights; (4) the debtors had made no attempt to pay the taxes for over 20 years; and (5) the debtors had not been timely and truthful in filing bankruptcy schedules. The court denied the motion to dismiss, holding that the IRS failed to prove that the primary purpose of the Chapter 12 filing has been other than for reorganization. ***In re* Dawes, 2008 Bankr. LEXIS 1564 (Bankr. D. Kan. 2008)**.

FEDERAL AGRICULTURAL PROGRAMS

2008 FARM BILL. After a second round of passage, presidential veto and legislative override, the final version of the 2008 Farm Bill has been enacted as Pub. L. No. 110-246, with Pub. L. No 110-234 repealed in the process.

COMMODITY LOANS. The CCC has announced that it will extend Marketing Assistance Loans and Loan Deficiency Payments for the 2008 crops of wheat, corn, grain sorghum, barley, oats, soybeans, rice, sunflower seed, rapeseed, canola, safflower, flaxseed, mustard seed, crambe, sesame seed, graded and non-graded wool, mohair, honey, dry peas, lentils, and small chickpeas. **73 Fed. Reg. 32675 (June 10, 2008)**.

DAIRY PRODUCT REPORTING PROGRAM. The AMS has adopted as final regulations amending the regulations governing the Dairy Product Mandatory Reporting Program authorized by the Farm Security and Rural Investment Act of 2002 to provide for timely, accurate, and reliable market information to facilitate more informed marketing decisions and promote competition in the dairy product manufacturing industry. **73 Fed. Reg. 34175 (June 17, 2008)**.

FEDERAL ESTATE AND GIFT TAXATION

GENERATION-SKIPPING TRANSFERS. The decedent's pre-1985 will established a residuary estate trust for the benefit of two children and two grandchildren and several remainder holders. The trustee filed a suit in state court to resolve a dispute among the beneficiaries as to the proper distribution of trust corpus at the termination of the trust. The parties reached a settlement agreement which was approved by the court. The IRS ruled that the changes in allocation and distribution of trust assets on termination did not subject the trust to GSTT because the changes occurred as a resolution of bona fide disputes. **Ltr. Rul. 200823003, Feb. 22, 2008**.

The U.S. Supreme Court has denied certiorari in the following case. The decedent's predeceased spouse had created a trust for the decedent which became irrevocable upon the death of the decedent's spouse in 1973. The trust provided the decedent with a testamentary power of appointment over the trust property and the decedent exercised the power in favor of the decedent's grandchildren. The estate filed a Form 706 which did not include any GSTT for the property transferred under the power of appointment but the estate included Form 8275-R, Regulation